Penalty clauses in commercial contracts

Stewart Hill & another v Stewart Milne Group [2011] CSIH 50.

The above case raises the interesting question as to how far a penalty clause in a contract may go and still remain enforceable. The general principle is that such a clause must represent a reasonable pre-estimate of likely loss in the event of one party acting in breach of the contract. The sums stipulated must not be unconscionable, exorbitant or to operate *in terrorem* in respect of the party in default.

In this case, the pursuers had contracted to sell their property for housing development. A minute of agreement stipulated that works in relation to a connection with the main public sewer system required to be completed and commissioned by 28 March 2008, failing which a sum of £5,000 required to be paid to the developers for each calendar month when that had not been achieved until the system had been completed. It was not disputed that the connection contracted for had not been completed by the defenders by the long-stop date of 28 March 2008. Initially, the defenders paid the sum stipulated under the contract but then ceased to do so in December 2008 which provoked the action being brought in the Sheriff Court.

The Sheriff upheld the pursuers' claim but was reversed by the Sheriff Principal who found that it was for the party seeking to show that the clause complained of was a penalty clause but then for the party relying on it to demonstrate that it was a genuine pre-estimate of losses and damage caused by the breach of contract. On appeal, the Inner House of the Court of Session found that it was for the defenders to show that the clause complained of was unenforceable and that they had failed to do so. What the Sheriff Principal had failed to consider was whether the defenders had any argument in support of the contention that the clause was an unenforceable penalty clause. He appeared to say that it was not only for the pursuers to state that the clause represented a genuine pre-estimate of their loss on breach of contract but also that it was for them to prove that such loss had indeed occurred. This, the Inner House, held was incorrect. There is no such requirement as the purpose of a penalty clause is to obviate proof, not only in relation to the quantification of loss, but also as to whether such loss has in fact materialised. The pursuers had averred a basis of loss calculated on a development value of £1.5m and a return on their investment at 4% on Royal Bank of Scotland rates. The decision of the Sheriff Principal was therefore reversed and the original decision of the Sheriff who first heard the case restored.

In other news, readers might be interested to note the recent decision of Lord Tyre in the case of *William Walton* (Chairman of Roadsense) *v Scottish Ministers* [2011] CSOH 131 which challenged the legality of the Aberdeen Western Peripheral Route on grounds of European Convention Rights and EU Law. The Court held that the complainers' rights had not been infringed by any failure of the State to provide them with legal representation during the course of the lengthy inquiry that was held into the proposed new roads scheme, based upon the Aarhus Convention. In addition, arguments based on the limited scope of the inquiry and alleged breaches of the EU Habitats Directive were also rejected. It will be interesting to see if the new road scheme actually now proceeds after all of this, given the state of public finances – and, from what I can gather, a severely diminished amount of public support.

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